Economic & Market Commentary

The dominant investment theme of the second quarter and in fact the whole first half, has been the liquidity addiction afflicting investors. With each fix of liquidity provided by central bankers, financial assets responded positively in almost Pavlovian fashion. U.S. stocks did so for the better part of the quarter, peaking in mid-May with a gain of 17% for the year to that date, while interest rates reached near record lows. Then in June, after Federal Reserve Bank Chairman Bernanke's press conference, where he intimated a tapering of Quantitative Easing, both the bond and stock markets hit an air pocket and turned in a negative month. The fear that the Federal Reserve (Fed) would reduce our liquidity fixes and worse, begin to tighten has given way to a series of gut-wrenching moves in both bonds and stocks that we have not seen in some time. In spite of this added volatility, U.S. stocks finished the quarter with positive returns (up 2% - 3% depending on the index), adding to their earlier strength for a stellar first half (up 12% - 15% depending on the index). It remains to be seen if the old saw about "sell in May and go away" will work again, but it has been a strong first half.

U.S. equities were, once again, the place to be for the quarter and the half, as they outperformed most other asset classes for both periods. Most foreign equity markets turned in negative quarters, and bonds got hit hard by the Fed Chairman's comments, with Treasuries producing negative returns for both the quarter and the half. The character of the equity market was similar to that of the first period. Small company stocks outperformed large, value outperformed growth, and low quality outdid high. In term of sectors, only three of the ten S&P sectors did better than the index for the quarter, and only four did so for the half. The latest period saw consumer discretionary, healthcare and financials outperform, while industrials about equaled the index. Consumer staples and other defensive sectors turned in negative returns, reversing their recent trends. This is consistent with the reversal of the "search for yield" caused by the Fed actions, as many high dividend payers began to lag late in the quarter. Two other laggards worth noting were energy and technology, both of which have been weak performers in recent quarters.

The liquidity addiction that the central bankers have created presents investors with an odd paradox. Monetary stimulus is generally employed when economic activity is weak, a condition not generally favorable for equities. It is withdrawn when economic conditions improve, a condition that should be favorable for equities. This is what the Fed's Quantitative Easing policy was designed to do. Stimulus has been added in the hope of boosting economic activity, and it will be reduced when the economy strengthens and becomes more self-sustaining. The paradox is that stocks have performed contrary to the general expectation. Bad economic news is deemed "good", as it ensures the Fed will continue providing liquidity, and good economic news is deemed "bad" as it raises the fear that liquidity injections will taper or cease. It is the embodiment of a "don't fight the Fed" market.

Most of the recent economic news points to a U.S. economy that is growing, but at a tepid rate. First quarter real GDP was reported at +1.7%, and second quarter was revised down from +2.4% to +1.8%, well below what had been expected three months ago. We have been in the +2.0% growth camp for the past several years, and see no reason to change that view. The Fed's latest forecast is for second half growth of +3.2%, which is probably optimistic. In order for the year to finish at +2%, which is our guess, the second half would have to produce growth in the area of +2.2%. We think that is reasonable. In our last quarterly outlook, we discussed the support for this view, and the following highlight the important points again:

- The consumer remains strong with a redressed balance sheet buoyed by higher asset prices, financial and housing, and less leverage. This is in spite of constrained incomes and reduced savings.

- Housing is no longer a drag, and is now a contributor although the recent spike in mortgage rates puts this positive contribution at risk.

- State and Local Governments finances are on the mend.

- Business confidence is improving which should lead to capital replacement of aging plant and equipment.

- Employment trends are improving with the June monthly report a pleasant surprise; however, full time employment and wages remain problematic.

In fact, looked at on its own, the private economy has been growing at +3%, while the government sector has declined. There are, of course, some offsets to these positives.

- The sequester will contract government spending even further and could reduce growth.

- A strong dollar could have a negative impact on exports.

- Increased taxes could impede consumer spending.

All of these factors demand close scrutiny and we will be watching for deviations from our expected path. However, we don’t think they will be enough to tip the economy and feel comfortable with our earlier stated view.

If we progress along this path, the odds marginally favor the Federal Reserve taking some action to taper the Quantitative Easing program over the next six to nine months. How this is accomplished is a key to the outlook for the second half. The mere hint of a policy change and the mention of a taper caused chaos in May and June, with the 10 year Treasury yield rising 100 basis points from 1.6% to 2.6%, and stocks suffering a decline of close to 6%. Further discussion and the approach of actual policy changes could spook both equities and bonds again. For this reason, the execution of liquidity withdrawal is crucial. Current interest rates are inordinately low, and normalizing them will be demanding. Under normal circumstances, the rate for 10 year Treasuries would approximate nominal GDP growth. Trend real economic growth of 3% and 2% normal inflation would equate to a rate of 5%. Getting from here (2.6%) to there is a large order – a near doubling of interest rates. If normalization is carried out in a measured fashion over a reasonable period of time (say the next year), that would be the best of all worlds. On the other hand, if the process is rapid and violent, as recent moves have been, the risk of an overshoot would increase, and asset volatility would be high. We have felt for some time that the 10 year at 4.5% - 5.0% would be tolerable and not do damage to equity valuations. An overshoot of that mark is another story. As we all know, interest rates are important to equities for a number reasons:

- They have an inflation component and a "real" component. High inflation is anathema to common stocks, so if rate increases are caused by rising inflation the outcome is generally not good. The real component is more sensitive to the level of the economic activity and the resultant demand for funds. A rise in this component is generally more tolerable for equities.

- They serve as a competitive comparator for equity returns, and a discount factor for equity valuation. Therefore, as rates increase stock valuation measures (Price/Earnings ratios) decrease.

- They are an important element of cost for the typical corporation. The decrease in rates in recent years had been an important contributor to profit growth during the recovery and profits have been the primary driver of common stock returns over that period. A reversal in rates will therefore have a negative impact on corporate earnings.

Today's inflation is low, and in fact declining. The outlook for the next several years is benign, as excess capacity exists for most of the inflation components. The primary exception to this is the level of bank reserves on the Fed's balance sheet, which have expanded because of the Quantitative Easing programs. These have yet to make their way into the real economy (monetary velocity is low), and until they do they should not be a problem. This circumstance could allow the primary impetus to rates to be the growth of the economy and the demand for funds. If investors recognize the paradox referred to earlier and allow a benign normalization, the process can be accomplished with minimal pain. The realization that "tapering" is not tightening, and that tightening the short end of the yield curve is some years away is, of course, a necessary condition.

The level of rates is not the only factor in this equation. The pace of increase, or velocity of change, is also crucial. If the rate of change is rapid, as in the past two months, markets can again be spooked, and asset volatility will increase.

We think it's likely that our massive liquidity fix will begin to taper over the next year. The good news is that in spite of a probable reduction in current domestic liquidity, there is plenty of ammunition left in the global system. The Bank Credit Analyst (BCA) states that in the post 2008 world there is a chronic glut of savings. They calculate that the "savings gap" ("private sector savings in excess of autonomous investment by the private sector") for the developed world stands at almost $3.5 trillion, with the developing world adding to that total. They also calculate that there is a worldwide deficit of about $1.5 trillion in safe assets for investment. BCA counts as "safe assets" sovereign government securities, some corporate debt and gold, and excludes equity securities, but excess liquidity always seeks return and could very well find its way into equity markets. In addition, Trim Tabs Investment Research estimates that more than $61 billion came out of bond mutual funds and ETF's in June; the biggest monthly withdrawal on record. As rates increase, we would expect to see more of this, and fully expect some of the cash to find its way into equities.

Conventional wisdom says that our liquidity addiction has been the impetus behind the advance in stock prices. This ignores the impact of earnings. Since the market and the economy bottomed in 2009, stocks have advanced about 140%, while underlying earnings have advanced about 150%. Earnings have been the primary driver, and stocks have not yet fully caught up with earnings. It has only been in the last 18 months or so that stocks have outpaced earnings, as perceived risk has diminished and the equity risk premium has begun to decline, resulting in P/E rates increasing. At the close of the quarter, the market (S&P 500) was valued at just under 15 times consensus 2014 operating earnings, in what we would consider a fair value zone. The equity risk premium (defined as the earnings yield minus the 10 year Treasury yield) was still well above normal. If the economic fundamentals for the balance of the year unfold as we have described earlier, we think there is room for valuation to improve. This assumes:

- Subdued growth

- Modest earnings gains

- A bias toward higher rates as Quantitative Easing tapers

- No violent rush to the exits by bond holders as rates rise toward normalcy

So, with an eye toward some of the potential problems mentioned earlier, we retain a positive bias toward equities. We do expect a high level of volatility as we transition to a more normal environment, but we will not try to anticipate this volatility as we expect it will not be long lived. As we wrote last time, our energies are better spent looking for compelling investment ideas.

Fixed Income Review and Outlook

Will they or won't they? And if they do, by how much? Those are the questions that have bedeviled the bond market for much of the year and became the source of much speculation in May. We refer, of course, to the Federal Reserve's decision to slow or stop the monthly purchases of $45 billion Treasuries and $40 billion Mortgage-Backed Securities (MBS). As was the case for equities, it was the specter of tapering that drove fixed income returns during the second quarter.

Bonds continued to disappoint investors with negative returns in the last quarter. Overall, the Barclays Aggregate Bond Index generated a -2.32% return for the three months ending in June and -2.44% year-to-date (YTD). It was the first time in five years that the bond market has experienced two sequential quarters of negative returns.

Treasuries, as hard as it may be to believe, were the safest bonds to own during the period, returning -1.92% for the quarter, and -2.21% YTD. This despite the dramatic rise in Treasury rates off their April lows. In the two months ending June 28, the yield on the five year note more than doubled, rising from 0.68% to 1.40%, the largest two month percentage increase in 50 years. A stronger than expected Non-Farm Payroll number in May, coupled with an even stronger revision to the April figure drove rates higher, as did Fed Chairman Ben Bernanke's testimony to Congress on May 22. During the question and answer phase of the testimony, Bernanke acknowledged the possibility of a tapering of Fed purchases. The Chairman further confirmed his intention to begin tapering later this year at the press conference following the Fed's June meeting. Based on the Fed's economic outlook, he concluded that a tapering would be warranted. He cited payroll growth of 200,000 per month over the past six months, a stronger job and housing market, improved consumer confidence and diminished downside risks to the recovery as evidence of that view. The Fed expects to end Quantitative Easing when the unemployment rate reaches 7.0%, presumably in mid-2014. The unemployment rate was 7.6% in June. The bond market reacted negatively, as the yield on the ten year note rose about 17 basis points following Bernanke's press conference and more than 40 basis points over the course of the next week. Remember, as bond yields go up, bond prices go down.

Bernanke was quick to point out that the taper was <u>not</u> a tightening, but a reduction in the amount of the stimulus the Fed was providing. He likened it to "letting up a bit on the gas pedal as the car picks up speed, not to beginning to apply the brakes". The publication of the Fed Governors' deliberations after the June meeting confirm that view, as a large majority of governors don't expect tightening (a rate hike) to come before 2015.

While we retain our long held bias toward higher rates, we think at present prices Treasuries represent fair value and look for them to trade close to these levels until around the end of the year.

In addition to the problem of how to wind down bond purchases in an orderly fashion, the Fed has another problem: inflation. It's not too high; it's currently too low. The Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditure Core Price Index, fell to a 50 year low in April. The CPI grew just 1.4% year over year in May. The Fed has a dual mandate to promote full employment and stable pricing. The Fed fears a sustained fall in prices, deflation, as much as it does high inflation. Deflation can slow economic activity as consumers delay purchases in anticipation of lower prices later. The bond market has reacted to the low level of price increases. The expected rate of inflation the market is pricing in via Treasury Inflation-Protected Securities (TIPS), fell during the quarter. This despite record monetary stimulus which economic theory tells us should spark inflation. We are watching the TIPS market in anticipation of an overly bearish view on inflation for an opportunity to add inflation protection.

Agencies also topped the overall market returning -1.91% for the quarter and -1.94% YTD. We are using callable agencies as a yield enhancing strategy. Ideally, we look for callable agencies with a coupon that will "step" or increase in the event a bond is not called on specified dates. The coupon step incentivizes issuers to call the bonds and provides investors with more certainty about callable cash flows.

Investment grade corporate bonds lagged the market with a -3.31% return, bringing the YTD total to -3.21%. Higher quality outperformed lower quality and financials led both utilities and industrials.

Overall corporate spreads moved in a narrow range until May, when they traded wider through a combination of uncertainty about the Fed's actions and high dealer inventories, as a result of near record bond issuance. The spread widening accelerated in June as record bond fund and fixed income ETF redemptions, over $60 billion in all, forced selling by portfolio managers into a market that was neither prepared for nor receptive to the unexpected supply. We intend to remain overweight corporate bonds. Even in a low positive growth environment, the incremental yield offered by corporates over Treasuries should cause corporates to outperform. We prefer credits with the ability to raise prices and those engaged in ongoing balance sheet repair.

Mortgages beat the overall index in the quarter, returning -1.96% and -2.01% so far in 2013; The strategy of favoring higher coupon mortgages over lower coupon securities continued to deliver better results in the second quarter. In light of our expectation that mortgage purchases will continue at least into mid-2014, we are using mortgages. The increase in interest rates should slow prepayment activity. In the face of investor demand for high quality assets with an attractive yield over Treasuries, the MBS should continue to be well supported in 2013.